REHEARING 8/20/08

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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF CHAPARRAL CITY WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO. W-02113A-04-0616 On remand from the Arizona Court of Appeals, No. 1 CA-CC 05-0002

CHAPARRAL CITY WATER COMPANY'S APPLICATION FOR REHEARING

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I. BRIEF SUMMARY OF THE COMPANY'S APPLICATION

Pursuant to A.R.S. § 40-253, Chaparral City Water Company ("Chaparral City" or "the Company") hereby applies to the Arizona Corporation Commission ("the Commission") for a rehearing of Decision No. 70441 (July 28, 2008) ("the Decision").[1] In the Decision, the Commission granted the Company a revenue increase of $12,143 on remand from the Court of Appeals, which is only 0.17 percent greater than the $7,310,464 revenue requirement authorized in Decision No. 68176 (Sept. 30, 2005).[2] The increase in operating income – the additional return dollars that would pay capital costs – is $7,441, which is only 0.57 percent greater than the operating income authorized in Decision No. 68176. Yet the Company's fair value rate base is $3,309,533 greater than its original cost rate base. The Decision effectively authorizes a return on that rate base increment of only 0.22 percent.

In other words, despite the Arizona Court of Appeals' clear instruction to use the fair value of the Company's property in setting rates,[3] and despite the fact that the Company's fair value rate base is $3.3 million larger than its original cost rate base, the Commission has set the Company's operating income at a level that is functionally equivalent to the result produced by multiplying the weighted average cost of capital by the original cost rate base. To achieve this result, the Commission arbitrarily reduced the Company's cost of equity, which was determined to be 9.3 percent in Decision No. 68176 and affirmed by the Court on appeal, by 200 basis points to only 7.3 percent to

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[1] The Company incorporates by reference its Remand Closing Brief, filed on March 5, 2008, and its Reply Brief, filed on March 21, 2008, and the evidence and arguments set forth therein, in support of this application.

[2] Decision at 41.

[3] *Chaparral City Water Co. v. Ariz. Corp. Comm'n*, No. 1 CA-CC 05-002 (Feb. 13, 2007) (Ex. A-R13) at 11-13, ¶¶ 13-16.

account for "inflation."[4] The Commission's manipulation of the rate of return in this manner renders the use of fair value meaningless. Arizona courts have indicated that adjusting the rate of return to ensure that the utility's earnings remain at the same level when fair value is used would be illegal.[5] It is illegal here as well.

The Commission should have applied the 7.6 percent rate of return that was used to determine the Company's operating income in Decision No. 68176 to the correct rate base – the fair value rate base. This approach complies with the decision and mandate of the Court of Appeals because it uses the fair value of Chaparral City's plant and property in a meaningful way.[6] It is also supported by court decisions that have addressed the appropriate rate of return in a fair value context.[7] Applying the rate of return to the correct rate base results in an increase in operating income of $251,525, and an increase in revenue of $409,666, which is a percentage increase of 5.6 percent. The Company would earn a 7.6 percent return on its <u>entire</u> rate base, rather than an effective return of only 0.22 percent on the difference between original cost and fair value.[8]

The primary justification for rejecting the Company's recommendation is that applying the weighted average cost of capital to the Company's fair value rate base "would over-compensate the Company for inflation."[9] That determination was erroneous

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[4] Decision at 37.

[5] *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 149-51, 294 P.2d 378, 385 (1956); *Ariz. Corp. Comm'n v. Citizens Utilities Co.*, 120 Ariz. 184, 190 n.5, 584 P.2d 1175, 1181 n.5 (App. 1978).

[6] *Chaparral City Water* at 11-13, ¶¶ 13-16.

[7] *E.g.*, *State ex rel. Utilities Comm'n v. Duke Power Co.*, 206 S.E.2d 269 (N.C. 1974); *City of Alton v. Commerce Comm'n*, 165 N.E.2d 513 (Ill. 1960).

[8] Staff recommended that the Company be allowed to earn a 0.00 percent return on the difference between its original cost and fair value rate bases or, alternatively, a 1.25 percent return. Ex. S-R5 at 5, 9. The Decision does not literally adopt, but approves of Staff's approach. Decision at 34. Obviously, a return of 0.22 percent is effectively zero.

[9] Decision at 41. *See also id.* at 30-32.

for several reasons, including the fact that half of the fair value rate base is based on the original cost of the Company's plant which, by definition, contains no inflation, and the Commission's erroneous belief that the Company's fair value rate base is simply "inflated" by some general measure of inflation instead of being a conservative estimate of current value.

The Decision also violates the prohibition against piecemeal ratemaking because it considers the impact of inflation in isolation, ignoring inflation's impact on Chaparral City's overall cost of service.[10] In this case, the Commission relied on the "danger of piecemeal regulation" in rejecting Chaparral City's request for purchased power and water adjustment mechanisms.[11] Yet, in a complete reversal of that position, the Commission considered only the impact of inflation on the Company's fair value rate base and its cost of equity, and ignored the evidence presented by the Company regarding the impact of inflation on the Company's earnings.[12] This was arbitrary and capricious.

In short, the Commission has ignored both the economic and legal underpinnings of the fair value standard and relied on methods based on the prudent investment/original cost approach, which, as the Court of Appeals explained, cannot be used.[13] The Commission's approach eliminates any legitimate increase in the Company's earnings,

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[10] *See Residential Utility Consumer Office v. Ariz. Corp. Comm'n*, 199 Ariz. 588, 593, 20 P.3d 1169, 1174 (App. 2001); *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 161 (App. 1978).

[11] Decision No. 68176 at 33.

[12] Chaparral City's operating expenses, for example, are impacted by inflation to a greater extent than either its rate base or the rate of return. *See, e.g.,* Ex. A-R4 at 42-43. A schedule that compares the impact of inflation on return dollars and operating expenses is attached at Tab A. Based on the Decision's assumed inflation rate, operating expenses would increase 2.4 times more quickly than the utility's operating income. This evidence was ignored by the Commission.

[13] *Chaparral City Water* at 13, ¶ 16.

even though the value of its property is at least $3 million greater than its book cost. At the same time, the Commission has ignored the impact of inflation on the rest of the Company's cost of service and its ability to actually earn its authorized rate of return. Consequently, the Decision should be vacated, and rates should be authorized that actually utilize the fair value of Chaparral City's utility plant and property in accordance with Arizona law.

II. THE COURSE OF PROCEEDINGS BEFORE THE COMMISSION AND THE COURT OF APPEALS

A. The Prior Proceedings Before the Commission

Chaparral City is an Arizona corporation engaged in the provision of water utility service. It serves approximately 12,000 customers within the Town of Fountain Hills and a portion of the City of Scottsdale, in Maricopa County.[14] On August 24, 2004, the Company applied for a determination of the fair value of its utility plant and property devoted to public service and increases in its rates and charges for service, based on a test year ended December 31, 2003.[15] The Company sought an increase in revenue of $1.77 million, or approximately 29 percent.[16] The Company's proposed increase in revenues would have produced an 8.21 percent rate of return on the Company's fair value rate base.[17] That rate of return, however, was based on the Commission's approval of automatic adjustment mechanisms that would allow the Company to recover increases in the cost of purchased water and purchased power. In case such mechanisms were not approved, the Company requested a return of 8.6 percent, based on a higher cost of

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[14] *See* Decision No. 68176 at 3.

[15] *See id.* at 1-3.

[16] *Id.* at 3.

[17] *See* Ex. A-6, Schedule A-1.

equity resulting from additional investment risk.[18]

Following the submission of testimony by the Company, the Commission's Utility Division ("Staff") and the Residential Utility Consumer Office ("RUCO"), a hearing was conducted before a duly authorized Administrative Law Judge, commencing on May 31, 2005.[19] Ultimately, the Commission issued Decision No. 68176 on September 30, 2005, authorizing an increase in revenue of $1,107,596 and establishing new rates and charges for service, which became effective on October 1, 2005.[20]

In setting rates in 2005, the Commission used what has become known as the "backing-in method," under which the weighted cost of capital (also called the "WACC") adopted by the Commission, 7.6 percent, was applied to the Company's original cost rate base ("OCRB") to determine the Company's authorized operating income. That operating income was then used to "translate" the 7.6 weighted cost of capital into a "fair value rate of return" of 6.34 percent.[21] In other words, operating income of $1,294,338 was divided into the Company's fair value rate base ("FVRB") of $20,340,298 to obtain a percentage return of 6.36 percent. Consequently, the fair value determination required by the Arizona Constitution was essentially meaningless.[22]

The method approved in Decision No. 68176 was supported by the testimony of

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[18] Decision No. 68176 at 16. *See also Chaparral City Water* at 26-27, 45-47 (discussing the denial of the risk adjustment).

[19] Decision No. 68176 at 2.

[20] *Id.* at 3, 28, 38-39, 41-44.

[21] *Id.* at 28.

[22] "For regulatory purposes, the rate of return is the amount of money earned by a public utility, over and above operating costs, expressed as a percentage of the rate base." Charles F. Phillips, Jr., *The Regulation of Public Utilities – Theory and Practice* 375-76 (Public Utilities Reports, Inc. 1993).

Staff and RUCO.[23] They both argued in 2005 that the rate of return (in dollars) produced by using fair value as the rate base should not exceed the rate of return that results when the weighted cost of capital is applied to the OCRB.[24] Staff's cost of capital witness, Mr. Ramirez, for example, testified that "[o]nly the cost of capital applied to the OCRB yields the correct earnings," expressly advocating for the use of "backing in" method.[25] RUCO did not bother to submit a proposed FVRB, and simply recommended that its OCRB be treated as the Company's FVRB, avoiding the need to back into the rate of return.[26]

Based on this testimony, the Commission stated in Decision No. 68176 that "no legitimate basis [has been] presented for departing from" the "backing in" method.[27] It also "found" as a matter of "fact" that the "rate of return methodology and resulting revenue increases proposed by Chaparral City would produce an excessive return on FVRB" because the operating income produced by applying the rate of return to the FVRB would exceed the operating income produced by using the original cost of Chaparral City's plant and property to set rates.[28]

B. <u>The Court of Appeals' Decision</u>

The Company sought rehearing of Decision No. 68176, which was denied by operation of law, and appealed the decision to the Arizona Court of Appeals pursuant to A.R.S. § 40-254.01.[29] In the appeal, two issues were presented for review:

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[23] Decision No. 68176 at 26-27.

[24] *See, e.g.,* Ex. S-3 at 33; Ex. S-4 at 3-5.

[25] Ex. S-4 at 5. As discussed below, RUCO's witness has made the same argument in the remand proceeding. *See, e.g.*, Ex. R-R2 at 5-6, 8.

[26] Decision No. 68176 at 9.

[27] *Id.* at 28.

[28] *Id.* at 39.

[29] *See Chaparral City Water* at 2-5, ¶¶ 2-5 (summarizing procedural history of case).

> 1. Does the "backing-in" method employed by the Commission in setting rates, under which Chaparral City's authorized operating income and revenues are based on the historic cost of the Company's property, violate Article XV, §§ 3 and 14 of the Arizona Constitution?
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> 2. Was the Commission's adoption of its Staff's recommended equity return of 9.3 percent and resulting 7.6 percent return on rate base arbitrary and unreasonable?[30]

With respect to the first issue, the Court held that "the Commission did not comply with requirements of Article 15, Section 14, of the Arizona Constitution when the Commission determined the operating income of Chaparral City using the original cost rate base instead of the fair value rate base."[31] The Court explained:

> Under the Arizona Constitution, a public utility is entitled to a fair return on the fair value of its property devoted to public use. ... The Commission is required to find the fair value of the utility's property at the time of the inquiry and to use that finding in setting just and reasonable rates. ... Here, the Commission determined Chaparral City's operating income based on its OCRB and then mathematically calculated a corresponding rate of return had the income based on the FVRB. Under this method, Chaparral City's operating income, and therefore its revenue requirements and rates, were not based on the fair value of its property, but on its OCRB, which does not comport with the Arizona Constitution.[32]

The Court did not direct the Commission to use a specific rate of return methodology, but emphasized that the "Commission cannot determine rates based on the original cost, or OCRB, and then engage in a superfluous mathematical exercise to identify the equivalent FVRB rate of return."[33] The court also explained that under the fair value standard, rates cannot be based on the investment made in the plant: "Rates cannot be based on

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[30] Ex. A-R9 at 5.

[31] *Chaparral City Water* at 28, ¶ 28.

[32] *Id.* at 11-12, ¶ 14 (citations omitted).

[33] *Id.* at 13-14, ¶ 17.

investment, but must be based on the fair value of the utility's property."[34]

With respect to the second issue on appeal, the Court ruled in favor of the Commission, and affirmed the 9.3 percent equity return authorized in Decision No. 68176.[35] The Court held that "Chaparral City's objections to the methodologies used in determining the cost of equity involve matters of judgment within the province of the Commission" and that Chaparral City failed to make "a clear and convincing showing that the Commission's decisions in these matters were unreasonable or unlawful."[36] Consequently, the cost of equity adopted by the Commission, which was based on Staff's recommendations, was not at issue on remand to the Commission.

Following a three month period, during which the Commission considered but did not seek review of the Court's decision by the Arizona Supreme Court, the Court issued its mandate to the Commission on May 29, 2007, commanding the Commission "that such proceedings be had in [this] cause as shall be required to comply with the decision of this court." After an unsuccessful attempt by the Company to discuss settlement, the Company filed schedules for the purpose of complying with the Court's decision and mandate, requesting adjustments to its rates and charges for service and the approval of a surcharge designed to recover the revenue deficiency together with carrying costs and additional rate case expense.[37]

Thereafter, procedural orders were issued by the Administrative Law Judge setting dates for filing testimony and for the hearing in the remand proceeding. A hearing was

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[34] *Id.* at 13, ¶ 16 (citing *Simms*, 80 Ariz. at 151, 294 P.2d at 382 (1956), and *Ariz. Corp. Comm'n v. Ariz. Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959)).

[35] *Id.* at 27-28, ¶¶ 48-49.

[36] *Id.* at 27-28, ¶ 48.

[37] *See* Ex. A-R3.

conducted on January 28 and 29, 2008, following which the parties filed closing briefs and their final schedules.[38] A recommended form of decision and order was issued by the Administrative Law Judge on June 30, 2008, and was formally considered and adopted by the Commission at an Open Meeting on July 17, 2008. The Decision was ultimately issued nearly 18 months after the Court's decision was issued and well beyond the nine-month deadline for the completion of an entire rate case. *See* A.R.S. § 40-256(A).

The Decision authorized Chaparral City a revenue increase of only $12,143, an increase in operating income (earnings) of only $7,441, even though Chaparral City's fair value rate base is $3.3 million more than its original cost rate base. The Commission achieved this anomalous result by reducing Chaparral City's 9.3 percent cost of equity (which was affirmed by the Court) to only 7.3 percent, producing a weighted average cost of capital of only 6.40 percent. By contrast, the "backing-in" method found unlawful by the Court produced a weighted cost of capital of 6.34 percent. In reality, the Commission again chose to ignore the fair value standard, and adopted a methodology ensuring that the Company's authorized level of operating income will be materially equivalent to the operating costs produced when the rate of return is applied to its OCRB.

III. OVERVIEW OF THE FAIR VALUE STANDARD AND THE PROPER APPLICATION OF THE RATE OF RETURN TO A FAIR VALUE RATE BASE

A. The Fair Value Standard

In Arizona, utility rates must be established on the basis of the "fair value" of the utility's property.[39] For example, in the seminal decision *Simms,* the Arizona Supreme

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[38] Decision at 4.

[39] Ariz. Const. art. 15, § 14. *See also US West Communications, Inc. v. Ariz. Corp. Comm'n*, 201 Ariz. 242, 244-46, ¶¶ 13-19, 34 P.3d 351, 354-55 (2001) (summarizing Arizona court decisions requiring the use of fair value).

Court stated:

> It is clear, therefore, that under our constitution as interpreted by this court, the Commission is required to find the fair value of the company's property and use such finding as a rate base for the purpose of calculating what are just and reasonable rates. ... While our constitution does not establish a formula for arriving at fair value, it does require such value to be found and used as the base in fixing rates. *The reasonableness and justness of the rates must be related to this finding of fair value.*[40]

Three years later, in *Arizona Water*, the Arizona Supreme Court followed *Simms* and squarely rejected the prudent investment approach, stating:

> This court has held that under our constitution the Corporation Commission must find the fair value of the properties devoted to the public use, and that in determining the fair value the Commission cannot be guided by the prudent investment theory nor can it use common equity as the rate base standard. ... *The amount of capital invested is immaterial. Under the law of fair value a utility is not entitled to a fair return on its investment; it is entitled to a fair return on the fair value of its properties devoted to the public use, no more and no less.*[41]

Simms and *Arizona Water* provide the basic constitutional framework for rate-making in Arizona, and have been consistently followed by Arizona courts. In 2001, the Arizona Supreme Court reaffirmed that in a monopoly setting, fair value is the "exclusive rate base" on which utility rates must be set.[42]

The United States Supreme Court has explained that under the fair value standard, rates are set "according to the actual present value of the assets employed in the public service."[43] "Fair value means the value of properties at the time of inquiry," not simply

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[40] *Simms*, 80 Ariz. at 151, 294 P.2d at 382 (emphasis added).

[41] *Ariz. Water,* 85 Ariz. at 203, 335 P.2d at 415 (emphasis added).

[42] *US West,* 201 Ariz. at 246, ¶¶ 18-19, 34 P.3d at 355.

[43] *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308 (1989).

their historic cost or the amount originally invested to build them.[44] Consequently, a utility benefits from increases in the value of the property it devotes to public service, but also bears the risk of obsolescence and other loss of property value:

> In theory the *Smyth v. Ames* fair value standard mimics the operation of the competitive market. To the extent the utilities' investments in plants are good ones (because their benefits exceed their costs) *they are rewarded with an opportunity to earn an "above-cost" return, that is, a fair return on the current "market value" of the plant.* To the extent utilities' investments turn out to be bad ones (such as plants that are canceled and so never used and useful to the public), the utilities suffer because the investments have no fair value and so justify no return.[45]

By allowing utility investors to be rewarded when the value of their plant increases, but requiring them to bear the burden when its value decreases, the "fair value standard mimics the operation of the competitive market."[46] Their investment is analogous to an investment in the stock of unregulated firms or other assets, which increase or decrease in value depending on various economic factors, as opposed to an investment in bond or

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[44] *Simms*, 80 Ariz. at 151, 294 P.2d at 382. *See also Arizona Pub. Serv. Co. v. Ariz. Corp. Comm'n,* 113 Ariz. 368, 370, 555 P.2d 326, 328 (Ariz. 1976) ("The company is entitled to a reasonable return upon the fair value of its properties at the time the rate is fixed."); *Consolidated Water Utilities, Ltd. v. Ariz. Corp. Comm'n,* 178 Ariz. 478, 482 n. 6, 875 P.2d 137, 141 n. 6 (App. 1993) ("The fair value rate base is the fair value of the company's properties within the state at the time the rate is fixed.").

[45] *Duquesne Light,* 488 U.S. at 308-09 (emphasis added) (citing *Smyth v. Ames*, 169 U.S. 466, 547 (1898)). *See also McCardle v. Indianapolis Water Co.*, 272 U.S. 400, 4010-11 (1926) ("It is well established that values of utility properties fluctuate, and that owners must bear the decline and are entitled to the increase."); *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 690 (1923) ("If the property, which legally enters into the consideration of the question of rates, has increased in value since it was acquired, the company is entitled to the benefit of such increase."); *City of Tucson v. Citizens Utilities Water Co*, 17 Ariz. App. 477, 480, 498 P.2d 551, 554 (1972) ("The [Arizona Supreme] Court reiterated [in *Simms*] that fair value meant 'value of properties at the time of inquiry' ... which figure will necessarily reflect the current cost of construction.").

[46] *Duquesne Light,* 488 U.S. at 308.

other debt instrument, which is fixed.[47]

The fair value standard "gives utilities strong incentive to manage their affairs well and to provide efficient service to the public."[48] Nevertheless, it has been replaced in most jurisdictions by what is called the "prudent investment" or "historical cost" approach, under which "the utility is compensated for all prudent investments at their actual cost when made (their 'historical' cost)."[49] Put simply, under the prudent investment standard, a utility's rates are based on the historic investment in its plant, as recorded on the utility's books, while under the fair value standard, a utility's rates are based on the current value of its property, not the original cost to build it. As explained by the Illinois Supreme Court,

> [T]he concept of fair value holds that it is the value of the utility's property devoted to public service upon which the reasonable rate must be returned. It is a *Value concept* and not a *Cost concept*. Stating it briefly, a cost rate base reflects the amount of invested capital, whereas a value rate base reflects the value of the assets which the utility has devoted to serving the public.[50]

Because the prudent investment approach relies on the recorded, book cost of the utility's plant and other accounting information, rather than the current value of the plant, the use of this method simplifies the rate-setting process.[51]

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[47] *See Railroad Comm'n v. Houston Natural Gas Corp.*, 289 S.W.2d 559, 565 (Tex. 1956) (discussing *San Diego Land & Town Co. v. City of National City*, 74 F. 79 (C.C.Cal. 1896), affirmed 174 U.S. 739 (1899)); Robert A. Webb, "Utility Rate Base Valuation in an Inflationary Economy," 28 *Baylor L. Rev.* 823, 825 (1976).

[48] *Duquesne Light,* 488 U.S. at 309.

[49] *Ibid.*

[50] *Union Elec. Co. v. Ill. Comm. Comm'n,* 396 N.E.2d 510, 516 (Ill. 1979) (emphasis added).

[51] The "most serious problem" associated with using the fair value method in setting rates was "the laborious and baffling task of finding the present value of the utility." *Duquesne Light*, 488 U.S. at 309 n.5 (quoting *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 292-94 (1923) (Brandeis, J. dissenting)).

In 1944, the Supreme Court ceased its practice of scrutinizing the rate-setting methodologies of public utility commissions under the fair value standard. The Court adopted in *Hope Natural Gas* what has become known as the "end result" test, declaring, in interpreting the federal Natural Gas Act:

> Under the statutory standard of "just and reasonable" it is the result reached and not the method employed which is controlling. ... It is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.[52]

Thus, the commission was not required to set rates based on the fair value of the pipeline company's property to satisfy constitutional requirements.

Arizona courts have made it clear, however, that the adoption of the "end result" test in *Hope Natural Gas* did <u>not</u> alter the express mandate of Article 15, Section 14 of the Arizona Constitution. Indeed, in *Simms*, the first Arizona decision to address *Hope Natural Gas*, the Arizona Supreme court squarely rejected the "end result" test, holding that the Arizona Constitution requires the fair value of a utility's property to be found and used as the rate base.[53] In short, regardless of what is currently done in other jurisdictions, the fair value standard applies to ratemaking in this State.

B. <u>How the Rate of Return Is Applied to a Fair Value Rate Base</u>

The Arizona Supreme Court rhetorically asked in *US West*, what is to be done with the finding of fair value?[54] The court answered that question by explaining that "fair value has been the factor by which a reasonable rate of return was multiplied to

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[52] *Federal Power Comm'n v. Hope Natural Gas,* 320 U.S. 591, 602 (1944). *See also Duquesne*, 488 U.S. at 310 (discussing *Hope*).

[53] *Simms*, 80 Ariz. at 150-51, 294 P.2d at 381-82. *See also US West,* 201 Ariz. at 245-46 & n.2, ¶¶ 10-19, 34 P.3d at 354-55 & n.2; *Ariz. Water,* 85 Ariz. at 203, 335 P.2d at 415.

[54] *US West*, 201 Ariz. at 245, ¶ 13, 34 P.3d at 354.

yield, with the addition of reasonable operating expenses, the total revenue that a corporation could earn. … That revenue figure was then used to set rates."[55] Nothing in that opinion, the Court's prior decision in this case, or in any other Arizona decision indicates, however, that it is permissible to manipulate the rate of return to produce a result that is equivalent to using original cost to set rates, or that the reasonableness of rates should be determined by reference to the end result produced under the prudent investment/original cost method. This would unlawfully conflate fair value with prudent investment, undermining the purpose of using the fair value of a utility's property as its rate base. Indeed, the Court strongly cautioned that "the Commission appears to be advocating the setting of rates based on investment made in plant. However, rates cannot be based on investment, but must be based on the fair value of the utility's property."[56]

1. Two Helpful Decisions That the Commission Ignored

The Company provided two decisions, *Duke Power* (which was also cited by Staff), issued by the North Carolina Supreme Court, and the *City of Alton*, issued by the Illinois Supreme Court, that specifically discuss the use of traditional cost of capital methodology to determine the appropriate rate of return in a fair value context. Although these cases demonstrate how a WACC-derived rate of return should be applied to a fair value rate base, the Commission simply dismissed them as inapplicable.

a. *City of Alton*

In *City of Alton*, the state commission authorized a return of 5.6 percent on a water utility's FVRB, resulting in an increase in revenue of 47.5 percent.[57] The intervenors

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[55] *Id.* (following *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978)).

[56] *Chaparral City Water*, at 13, ¶ 16 (citing *Ariz. Water,* 85 Ariz. at 203, 335 P.2d at 415, and *Simms*, 80 Ariz. at 151, 294 P.2d at 382).

[57] 165 N.E.2d at 515-16.

appealed the decision to the circuit court, which disallowed the return on the FVRB on the basis that it produced an excessive return to the common stockholders.[58] The circuit court calculated the net income available for distribution to the stockholder, and divided that amount by the book value of the utility's common equity, which resulted in an equity return of 17 percent.[59] The Illinois Supreme Court reversed and upheld the return on the FVRB, explaining that the circuit court had erroneously assumed that the "return on the original common stock investment was the relevant figure in determining the reasonableness of an overall rate of return."[60] The court stated:

> It is well established in Illinois that the utility is entitled to a reasonable overall return on the fair value of its property, not the original cost. This provides a flexible rate-making standard which is equally applicable in periods of rising and falling price levels. ... It would be inconsistent to judge the overall return on the basis of fair value but judge the return accruing to common shareholders on the basis of a par value which is essentially original cost. ***The significant figure is the rate of return on common stock valued at fair value.***[61]

The court also explained that there are several ways to determine a reasonable rate of return on the utility's common equity valued at fair value. For example, the "fair value attributable to the common stock might be determined by subtracting the par [i.e., book] value of debt and preferred stock, to reflect the fact that all increments in value belong to the equity, or by dividing fair value in the same percentages as book value."[62] Both approaches provide a rational framework for developing a fair rate of return by using the cost of capital in a fair value context.

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[58] *Id.* at 516, 519.

[59] *Id.* at 519.

[60] *Ibid.*

[61] *Ibid.* (emphasis supplied). *See also Union Electric*, 396 N.E.2d at 516 (quoting and following *City of Alton* and rejecting the *Hope* "end result" test advocated by the commission).

[62] 165 N.E.2d at 520.

The first approach recognizes that any increase (or decrease) in property value inures solely to the benefit (or detriment) of the equity holders. Thus, the difference between the OCRB and the FVRB (which Staff called the "Fair Value Increment" in its testimony[63]) would be added to the equity balance, and the adjusted equity balance would then be used in the weighted cost of capital calculation to determine the cost of capital/rate of return. The second approach assumes that the Fair Value Increment is funded by all of the components of the capital structure, which reduces the potential benefit to the equity holders when the Fair Value Increment is positive, but also reduces the adverse impact on the equity holders when the Fair Value Increment is negative.

b. *Duke Power*

In *Duke Power*, the North Carolina Supreme Court addressed the appropriate rate of return in a fair value context. When this case was decided, North Carolina's statute governing rate-setting required that "the Commission shall fix rates which will enable a well managed utility to earn a 'fair rate of return' on the 'fair value' of its properties 'used and useful' in rendering its service." Thus, North Carolina's rate-setting requirements were virtually identical to Arizona's.[64]

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[63] *See, e.g.*, Ex. S-R5 at 5-7.

[64] 206 S.E.2d at 276. North Carolina General Statute § 62-133(b), in its entirety, provides as follows:

"(b) In fixing such rates, the Commission shall:

"(1) Ascertain the fair value of the public utility's property used and useful in providing the service rendered to the public within this State, considering the reasonable original cost of the property less that portion of the cost which ahs been consumed by previous use recovered by depreciation expense, the replacement cost of the property, and any other factors relevant to the present fair value of the property. Replacement cost may be determined by trending such reasonable depreciated cost to current cost levels, or by any other reasonable method.

"(2) Estimate such public utility's revenue under the present and proposed rates.

"(3) Ascertain such public utility's reasonable operating expenses, including actual investment currently consume through reasonable actual depreciation.

In setting rates for Duke Power, however, the state commission used an approach similar to the "backing-in" method used to set Chaparral City's rates in Decision No. 68176. The commission determined that Duke Power's cost of equity was 11 percent. That equity cost was used, along with the annual interest on the utility's debt and dividends on its preferred stock, to compute the amount that would be a "fair" dollar return to the utility on the capital historically invested in its properties, i.e., the utility's OCRB. That dollar return was then used to compute an overall return of 7.05 percent on the fair value of the utility's properties.[65] The court held that this approach violated the fair value standard because it produced the same total dollar return as if "the fair value of the properties had been exactly the same as Duke's actual net investment in the properties."[66]

The court also reaffirmed that the Fair Value Increment must be recognized as a component of the utility's equity in determining the rate of return:

> The "fair value" increment (fair value of the plant less original cost, depreciated) found by the Commission was approximately $95,500,000. For rate of return purposes, this increment must be added to the equity component of Duke's actual investment in its electric plant. *Duke is entitled, under*

"(4) Fix such rate of return on the fair value of the property as will enable the public utility by sound management to produce a fair profit for its stockholders, considering changing economic conditions and other factors, as they then exist, to maintain its facilities and services in accordance with the reasonable requirements of its customers in the territory covered by its franchise, and to compete in the market for capital funds on terms which are reasonable and which are fair to its customers and to its existing investors.

"(5) Fix such rates to be charged by the public utility as will earn in addition to reasonable operating expenses ascertained pursuant to paragraph (3) of this subsection the rate of return fixed pursuant to paragraph (4) on the fair value of the public utility's property ascertained pursuant to paragraph (1)."

[65] *Id.* at 281.

[66] *Ibid.*

> *G.S. § 62-133(b), to earn the same rate of return on this increment as it is entitled to earn on the retained earnings (surplus) which it has reinvested in its plant.* The wisdom of the statute is not for us or for the Commission. The Legislature has so decreed and its mandate must be observed by the Commission.[67]

Duke Power is consistent with the view of the Illinois Supreme Court in *City of Alton* that the difference between OCRB and FVRB – the Fair Value Increment – should be recognized in determining the rate of return by adjusting the utility's equity balance to include the Fair Value Increment and then using the adjusted equity balance to determine the cost of capital. That approach complies with the fair value standard by allowing the utility and its equity investors to benefit from increases in the value of the property devoted to public service, but also requiring the utility and its equity investors to bear the risk of obsolescence and other loss of property value, which would result in a downward adjustment to the utility's equity balance.

c. The Commission Rejected *City of Alton* and *Duke Power* on Irrelevant and Improper Grounds

The Commission dismissed *City of Alton* on the basis that the methods described "seem to be 'after-the-fact,' as opposed to methods to use ...."[68] That characterization is erroneous. Courts normally review agency decisions "after-the-fact" and provide guidance for future decision-making, as the Court did in this case. In addition, the *City of Alton* court stated that "[s]everal methods of computing [the rate of return on the FVRB] might be used" and, after describing those methods, concluded that regardless of the method chosen, "in this case the return on fair value attributable to common stock falls

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[67] *Ibid.* (emphasis added). *See, e.g., Utilities Comm'n v. Gen. Tele. Co.*, 189 S.E.2d 705, 720 (N.C. 1972) (discussing risk resulting from a utility's debt ratio).

[68] Decision at 25-26.

within the range of the testimony," i.e., it was supported by the record.[69] Consequently, the discussion ignored by the Commission was relevant to the court's holding.

The Commission rejected *Duke Power* because "[t]he Court clearly indicated that, under the North Carolina statute, the North Carolina Commission had to apply the cost of equity to the fair value increment."[70] That statement is wrong. In fact, as previously explained, North Carolina General Statute § 62-133(b) simply provided that "the Commission shall fix rates which will enable a well managed utility to earn a 'fair rate of return' on the 'fair value' of its properties 'used and useful' in rendering its service."[71] Thus, North Carolina law was analogous to Arizona law; there was no statute mandating that the commission apply the cost of equity to the fair value increment, as the Commission erroneously stated. Instead, the requirement that the Fair Value Increment be added to the utility's equity balance was the result of the North Carolina Supreme Court's legal interpretation of the statute's requirement that rate be based on fair value, as *Duke Power* plainly states.[72]

The Commission also provided a lengthy quotation from *Duke Power*, with no explanation or discussion of that quotation's relevance to this case.[73] The Commission seemed to suggest that the *Duke Power* court held that the inclusion of the Fair Value Increment in the utility's capital structure should automatically reduce the overall rate of return. Actually, the court stated that the addition of the Fair Value Increment to the utility's equity balance might (not must) result in a lower cost of capital based on two

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[69] 165 N.E.2d at 520.

[70] Decision at 25.

[71] 206 S.E.2d at 276.

[72] *Id.* at 280 (quoting *General Tele.*, 189 S.E.2d at 719-20).

[73] Decision at 24-25 (quoting *Duke Power*, 206 S.E. at 282).

considerations, (1) reduced financial risk and (2) reduced firm-specific risks.[74] Neither of these considerations is applicable in this case, which is presumably why the Commission failed to discuss them in the Decision.

First, the *Duke Power* court stated that including the Fair Value Increment in the utility's equity balance "enlarges the equity component in relation to the debt component so that the risk of the investor in common stock is reduced."[75] In other words, the Commission should consider whether the financial risk resulting from the utility's capital structure has changed. Previously, the Commission explained to the Court of Appeals that "[c]apital structure affects financial risk. A greater percentage of debt in a capital structure results in higher financial risk and a higher cost of equity. Increasing debt increases leverage and thus risk."[76] To account for financial risk associated with leverage (debt), the Commission uses a direct financial risk adjustment, and either increases or decreases the cost of capital based on the percentages of debt and equity in the utility's capital structure.[77]

If the *Duke Power* approach had been used in this case, the percentage of equity in Chaparral City's capital structure would increase from 58.8 percent to 65.5 percent, while the percentage of debt would decrease from 41.2 percent to 34.5 percent. However, Chaparral City proposed the conservative approach, i.e., that the Commission simply

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[74] *Duke Power*, 206 S.E. at 282.

[75] *Ibid.*

[76] Ex. S-R8 at 27. *See also General Tele.*, 189 S.E.2d at 720. Note that it is ratio of debt to total capital that matters, not the dollar amounts of debt and equity. The WACC methodology relies on the percentages of debt and equity in the utility's capital structure, as discussed below.

[77] *See, e.g., Gold Canyon Sewer Co.*, Decision No. 69664 (June 28, 2007) 27-29 (downward adjustment of 100 basis points to cost of equity where capital structure consisted of 100 percent equity); *Arizona-American Water Co.*, Decision No. 69440 (May 1, 2007) 18-20 (upward adjustment of 100 basis point to cost of equity based on highly leveraged capital structure).

apply the weighted cost of capital to its FVRB. This results in no change to the percentages of debt and equity in the Company's capital structure, as shown below:

Company Approach

Item	Amount	Capitalization Percent	Cost (%)	OCRB %	Cost in Dollars
Debt	$8,380,203	41.2%	5.10%	2.10%	$427,390
Equity	$11,960,095	58.8%	9.30%	5.47%	$1,112,289
Total	$20,340,298	100.00%		7.57%	$1,539,679

Under this approach, the Fair Value Increment is supported by the utility's total capital, including its outstanding debt, and the percentage of equity in Chaparral City's capital structure remains 58.8 percent. The Commission previously told the Court of Appeals that "on average, the capital structure of the average sample water utility is pretty similar to Chaparral City … [s]o it is not unreasonable to assume they have the same financial risk."[78] Therefore, no adjustment for financial risk is appropriate, and the first consideration noted by the *Duke Power* court does not apply in this case.

Second, the *Duke Power* court stated that the use of fair value may result in future increases in the utility's rate base, which would provide equity investors "an assurance of growth of dollar earnings per share, over and above the growth incident to the reinvestment in the business of the company's actual retained earnings."[79] This consideration, however, is irrelevant because, other than financial risk, regulatory risk and other types of unique or firm-specific risks are not considered by the Commission in estimating the cost of equity.[80]

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[78] Ex. S-R8 at 27 (quoting Tr. 366).

[79] *Duke Power*, 206 S.E.2d at 282.

[80] *See, e.g., Arizona Water Co.*, Decision No. 68032 (Nov. 14, 2005) 38 ("Unique risk does not affect the cost of equity, because firm-specific risk can be eliminated through shareholder diversification.").

This case provides a prime example of the Commission's policy of excluding unique risk in determining the cost of equity. In the initial phase of this case, Chaparral City's witnesses identified a number of specific aspects of Arizona's rate-setting system that affect cash flows and make it more difficult for Chaparral City to actually earn its authorized rate of return, increasing risk. These included:

- Use of an historic test period with limited out-of-period adjustments, which delays recovery of costs associated with new utility plant.
- The exclusion of construction work in progress in rate base.
- Lack of automatic adjustment mechanisms and balancing accounts that allow Chaparral City to promptly recover increases in significant operating expenses beyond the utility's control.
- The imposition of inverted-tier declining block rate structures on water utilities to conserve water, without any adjustment to the utilities' revenues to account for changes caused by reduced consumption.[81]

None of the water utilities in Staff's sample group do business in Arizona (other than American States Water Company, which owns Chaparral City), and they are not exposed to the rate-setting policies and methods employed in this jurisdiction.[82] These policies reduce cash flow and increase investment risk.[83]

Staff opposed any adjustment to the cost of equity based on firm-specific risk because regulatory and other types of unique risk are "related to the risk of an individual project or firm; therefore [such risk] can be eliminated through diversification. Investors can eliminate unique risk by holding a diversified portfolio. <u>Unique risk is not measured</u>

[81] *See* Ex. A-7. at 13-20; Ex. A-8 at 3-4, 25; Ex. A-11 at 18-19; Ex. A-12 at 4-8.

[82] *See* Ex. A-15 (describing the sample group of publicly traded water utilities used to estimate the cost of equity).

[83] Ex. A-8 at 25.

by beta, nor does it affect the cost of equity because these firm-specific risks can be eliminated through shareholder diversification."[84] The Commission adopted Staff's recommendations.[85]

On appeal, the Company argued that the Commission erred in failing to adjust the cost of equity to account for the risk related to Arizona's particular rate-setting system.[86] The Commission argued in response that unique risk is irrelevant to the cost of equity.[87] According to the Commission, "unique risks that investors can eliminate through diversification are not relevant for the purposes of computing a firm's cost of capital."[88] In short, the Commission's position on appeal was that although there may be wide variations in the rate-setting methods used in each jurisdiction, ultimately, each water utility's investment risk is the same as the industry as whole. The Court accepted the Commission's argument and ruled that unique risk is irrelevant to the cost of equity.[89]

Thus, it appears that the Commission is acting arbitrarily by taking one position (that regulatory risk is irrelevant to the cost of equity) in the initial phase of this case, and then, on remand, taking the opposite position in order to justify lowering the Company's equity return. This arbitrary approach to rate-making is itself unlawful:

> The risks a utility faces are in large part defined by the rate methodology because utilities are virtually always public

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[84] Ex. S-3 at 10 (emphasis added). *See also id.* at 35-39; Ex. A-R6 at 24 (summarizing Staff's position on regulatory and firm-specific risk).

[85] Decision No. 68176 at 25-26.

[86] Ex. A-R9 at 51-57.

[87] Ex. S-R8 at 23-27.

[88] *Id.* at 23.

[89] *Chaparral City Water* at 25-27, ¶¶ 43-47. The Court specifically noted the testimony of Mr. Ramirez, Staff's cost of capital witness, "that beta represents systematic risk of the industry, which is the only risk relevant to the cost of equity determination." *Id.* at 27.

> monopolies dealing in an essential service, and so relatively immune to the usual market risks. Consequently, *a State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions.*[90]

In short, *City of Alton* and *Duke Power* provide two authoritative examples illustrating how the cost of capital methodology should be used to derive a rate of return that satisfies the fair value standard. The approach advocated by Chaparral City is the more conservative approach described in *City of Alton*, i.e., the 7.6 cost of capital should be applied to the fair value rate base without increasing the equity balance, which produces a lower revenue requirement than the *Duke Power* approach, in which the utility's equity balance is adjusted. The Commission, unfortunately, dismissed both decisions, and instead lowered Chaparral City's rate of return to 6.34 percent by reducing the Company's cost of equity from 9.3 percent to only 7.3 percent. As shown below, the justification for doing so is both conceptually and legally flawed.

IV. SUMMARY OF THE PARTIES' RECOMMENDATIONS AND THE COMMISSION'S DECISION

The parties to the remand proceeding presented different recommendations concerning the appropriate rate of return to be used in connection with a FVRB. Only the Company's recommendation, however, actually uses the fair value of the Company's utility plant and property in a meaningful way in setting rates and, therefore, is consistent with the Court of Appeals' decision and mandate. Chaparral City applies the percentage rate of return used in Decision No. 68176, based on the weighted cost of capital, to the correct rate base. The application of the WACC-derived cost of capital to the FVRB is also consistent with the decisions of other jurisdictions, including the *City of Alton* and

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[90] *Duquesne Light*, 488 U.S. at 314-15 (emphasis added).

Duke Power decisions discussed above, which recognize that the difference between OCRB and FVRB is being financed with investor-supplied capital.

Staff and RUCO, in contrast, proposed methodologies that are rooted in original cost concepts, i.e., historic investment in plant, notwithstanding the Court of Appeals' decision to the contrary. Both methods were approved by the Commission.

A. <u>Staff's Method Is the Prudent Investment Method</u>

Staff recommended that the Commission compute a "fair value rate of return" (called the "FVROR"), which is then applied to Chaparral City's FVRB. As in *Duke Power*, Staff's two alternatives involved the restatement of Chaparral City's capital structure into three components, long-term debt, common equity and the Fair Value Increment, with the latter being equal to the difference between Chaparral City's FVRB and its OCRB. In *Duke Power*, the court explained that the utility is entitled under the fair value standard "to earn the same rate of return on this increment as it is entitled to earn on the retained earnings (surplus) which it has reinvested in its plant."[91] Staff, in contrast, applied a rate of return of **<u>0.00 percent</u>** in its preferred alternative (called Alternative 1) to the Fair Value Increment.[92]

The following is a comparison of the rates of return and return dollars produced by Staff's preferred alternative and a prudent investment/original cost approach, under which the weighted cost of capital is applied to Chaparral City's OCRB to derive the rate of return:

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[91] *Duke Power*, 206 S.E.2d at 281.

[92] Ex. S-R5 at 5 (Alternative 1). In Staff's other alternative, the Company would be authorized a return of only 1.25 percent on the Fair Value Increment, while being allowed to earn a return of 7.6 percent on the remainder of the Company's invested capital. *See id.* at 9 (Alternative 2).

OCRB Approach

Item	Amount	Capitalization Percent	Cost (%)	FV (%)	Cost in Dollars
Debt	$7,016,675	41.2%	5.10%	2.10%	**$357,850**
Equity	$10,014,090	58.8%	9.30%	5.47%	**$931,310**
Total	$17,030,765	100.00%		7.57%	**$1,289,161**

Staff Alternative 1

Item	Amount	Capitalization Percent	Cost (%)	FV (%)	Cost in Dollars
Debt	$7,016,675	34.50%	5.10%	1.76%	**$357,850**
Equity	$10,014,090	49.23%	9.30%	4.58%	**$931,310**
FVRBI	$3,309,533	16.27%	**0.00%**	0.00%	**$0**
Total	$20,340,299	100.00%		6.34%	**$1,289,161**

Staff conceded that Alternative 1 produces the same result as the "backing-in" method; any difference between the two methods is solely the result of rounding off some numbers before computing the operating income.[93] Thus, Staff's Alternative 1 was simply another back-door method of determining operating income that is equivalent to operating income produced by means of the method declared unlawful by the Court.

Staff's witnesses attempted to justify this transparent methodology on the basis of "financial theory." This "financial theory," however, is the prudent investment method. For example, Staff's witness explained that "[t]he fundamental, underlying premise on which original cost rate base regulation is based is the recognition that a utility should be granted an opportunity to earn its prudently-incurred costs, including capital costs."[94] He also explained that "[s]ince the increment between fair value rate base and original cost rate base is not financed with investor-supplied funds, it is logical and appropriate, from a

[93] Ex. A-R14; Ex. A-R9 at 5-7 and TMZ RJ-1.

[94] Ex. S-R6 at 7.

financial standpoint, to assume that this increment has no financing cost."[95] During the hearing, he testified:

> The difference between original cost rate base and fair value rate base is not supported by investment because it is not dollars that are provided by investors, the $17 million versus the $20 million. ...
>
> It is not appropriate for the company's investors to [earn a return on the FVRB increment] because investors did not put up the money to support that differential. Investors are entitled to an opportunity to earn a fair return on their invested dollars. But the dollars that they did not invest are not entitled to a return on. [sic] Otherwise, it becomes an adder to the equity owners.[96]

In short, Staff's method was based on the prudent investment/original cost approach, which cannot be used in Arizona, as the Court told the Commission.[97] In other words, Staff's recommendation "would fully compensate the Company's investors for their investment"[98] as long as the investment does not exceed the original cost of the utility's plant. This method plainly violates Arizona law.

Nevertheless, the Commission expressly approved Staff's method, describing this method as "adjust[ing] the cost of capital to reflect the cost of the portion of the capital structure that is funded by neither debt nor equity, but exists due to inflation."[99] On its face, this statement is absurd, given that Staff's approach ignored approximately

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[95] *Id.* at 5.

[96] Tr. at 348-49. Staff's other witness likewise argued that assigning a "zero cost" to the Fair Value Increment is appropriate because "[t]he difference between the FVRB and OCRB has not been financed by any identifiable debt or equity capital on the utility's books. Ex. S-R4 at 18.

[97] *See Chaparral City Water* at 13, ¶ 16. ("[T]he Commission appears to be advocating the setting of rates based on the investment made in the plant. However, rates cannot be based on investment, but must be based on the fair value of the utility's property.").

[98] Ex. S-R5 at 9.

[99] Decision at 34.

$3.2 million of debt and equity on the Company's books by reducing the amount of debt from $8,363,309 to $7,016,676 and reducing the amount of equity from $11,901,727 to $10,014,090.[100] Nevertheless, the Commission determined that this unlawful method "would result in a fair rate of return on FVRB."[101]

B. <u>RUCO's "Inflation" Adjustment Violates the Fair Value Standard</u>

The Commission also approved of the method recommended by RUCO, under which the weighted cost of capital is reduced by an inflation component that was estimated to be 2.0 percent.[102] RUCO's witness, Dr. Johnson, testified that the prudent investment/original cost method is the only method that produces an appropriate <u>end result</u>, and that if the current value of the utility's property is considered in setting rates, the rate of return must be lowered to offset the effect of deviating from the prudent investment/original cost standard. This result-driven approach also violates Arizona law.

Dr. Johnson argued that "[t]he fundamental premise of the return on rate base approach to ratemaking is to allow utilities with an opportunity to recover their actual costs, including their actual cost of capital, consistent with what occurs in competitive industries."[103] But under the fair value standard, which is intended to mimic the operation of the competitive market, the rate of return is applied to the fair value of the utility's property, not to its OCRB or to the investment recorded on its books.[104] Various court decisions, including *City of Alton* and *Duke Power*, discussed above, have approved the application of the cost of capital to a FVRB.

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[100] *Compare* Decision No. 68176 at 16 (showing the capital structure approved by the Commission) *with* Ex. S-R5 at 5. *See also* Tr. at 136-37.

[101] Decision at 34.

[102] Id. at 34-35.

[103] Ex.R-R2. at 11.

[104] *E.g., Duquesne Light*, 488 U.S. at 308.

Dr. Johnson nevertheless contended that "a return that fully compensates investors for the actual level of capital costs, without unduly burdening customers," is produced only "when the WACC is applied to an original cost rate base."[105] Again, this is simply the prudent investment approach. When the weighted cost of capital is applied to the OCRB, the utility's return is limited by its historic investment in plant. When the weighted cost of capital is correctly applied to the FVRB, the utility is allowed to earn a fair return on the current value of its property.[106] The fact that the return dollars may be greater (or less) than would be produced under the prudent investment approach is irrelevant: The fair value standard is intended to recognize increases (and decreases) in property values, and therefore the return dollars may be higher or lower than the return dollars produced using original cost.[107]

Dr. Johnson finally assumed that application of the weighted cost of capital to the OCRB always yields an "appropriate result," and therefore should serve as the benchmark for rate-making in Arizona:

> The *end result* of applying the WACC (including an estimate of the cost of equity) to an OCRB is to provide an opportunity to earn a just and reasonable return. The *reasonableness of this end result* has been confirmed over multiple decades by thousands of carefully reasoned decisions by both regulators and appellate courts throughout the United States. ... [A]pplying the WACC to a consistently higher rate base valuation (fair value) will necessary achieve an unjust and *unreasonable result* – one that overcompensates stockholders, and unnecessarily burdens customers.[108]

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[105] Ex. R-R2 at 3 (emphasis added).

[106] *See, e.g., Duke Power*, 206 S.E.2d at 281; *City of Alton*, 165 N.E.2d at 519.

[107] Ex A-R7 at 13-16. *See also McCardle*, 272 U.S. at 410-11; *Bluefield Waterworks,* 262 U.S. at 690.

[108] Ex. R-R2 at 5-6 (emphasis added). *See also E.g.*, Ex. R-R2 at 8 ("First and foremost, if the *end result* of multiplying WACC times OCRB is just and reasonable, then the *end result* of multiplying WACC times FVRB will be excessive … .") (emphasis added).

This, of course, is the *Hope Natural Gas* "end result" test, which, as discussed above, has been squarely rejected by the Arizona courts.[109] At bottom, RUCO claimed that since other jurisdictions use original cost, the rate of return must be manipulated to ensure that using the fair value of Chaparral City's plant as the rate base will produce an equivalent result.[110]

Despite the obvious conflict between RUCO's position and Arizona law, the Commission approved RUCO's approach, claiming that "RUCO's method analyze[ed] the inflation contained in the estimates of the cost of equity and adjust[ed] the cost of capital to eliminate the inflation."[111] Actually, all Dr. Johnson did was estimate the general inflation in economy, based on comparing yields of certain Treasury securities,[112] and assume that the same inflation affects both the FVRB (which is the average of reconstruction cost and original cost) and the cost of capital in the same way.[113] He provided no estimate of the amount of inflation in Chaparral City's FVRB, and ignored

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[109] *Simms*, 80 Ariz. at 150-51, 294 P.2d at 381-82. *See also* Ex. A-R7 at 24-25.

[110] *E.g.*, Ex. R-R2 at 9 ("Any level of capital costs can be recovered using a lower percentage figure if the percentage figure is applied to a rate base valuation that is growing over time as a result of increases in reproduction costs.). It should be noted that while "original cost" rate bases are used in other jurisdictions, the methodologies used to determine a utility's rate base vary widely from jurisdiction to jurisdiction, and include, for example, projected or forecasted test years. Ex. A-R2 at 12-13. The use of projected operating expenses and rate base elements allows utilities a "hedge" against the inflationary impacts on both operating expenses and rate base and provides a better opportunity for utilities to actually earn their authorized rate of return. In this case, Chaparral City's fair value rate base is only 19 percent greater than its original cost rate base, which is well within the range of valuation differences resulting from different test year methodologies employed in "original cost" jurisdictions. *Id.*

[111] Decision at 34.

[112] Decision at 34-35.

[113] *See, e.g.*, Ex. R-R2 at 16 ("the thrust of my [direct] testimony was clearly focused on avoiding overcompensation for *general inflation* – inflation that is recognized by equity investors generally, because such compensation is already compensated for within the cost of equity capital") (emphasis added); Tr. 12-13.

the fact that half of the FVRB consists of plant valued at original cost, which by definition has no inflation component.[114]

The Commission used RUCO's unlawful approach. But rather than reducing the weighted cost of capital from 7.6 percent to 5.6 percent, as proposed by RUCO, the Commission reduced the Company's cost of capital from 9.3 percent to 7.3 percent, and recalculated the weighted cost of capital to arrive at a new cost of capital/rate of return of only 6.40 percent.[115] Not surprisingly, the end result (in dollars) is remarkably similar to the result produced by multiplying the 7.6 percent weighted cost of capital determined by Decision No. 68176 by Chaparral City's OCRB.[116]

V. SPECIFIC GROUNDS FOR REHEARING

The Commission justified its after-the-fact reduction in Chaparral City's cost of equity, which was set at 9.3 percent in Decision No. 68176 and affirmed by the Court on appeal, on several grounds, asserting, in summary, that (1) as long as the rate of return is applied to a FVRB, the prudent investment method can be used to set rates; (2) the weighted cost of capital cannot be applied to an FVRB; and (3) application of the cost of capital to a FVRB produces an excessive return because it "over compensates" for inflation. As explained below, each of these justifications is erroneous.

A. The Commission Unlawfully Manipulated The Rate of Return to Produce an End Result That Is Equivalent to Using Original Cost

The Commission was ordered by the Court to set rates that are based on the fair value of Chaparral City's utility plant and property. As explained, under the fair value

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[114] Ex. A-R4 at 44-47; Ex. A-R 7 at 37-39.

[115] Decision at 37.

[116] The total revenue requirement authorized in Decision No. 68176 was $7,310,464, while the total revenue requirement authorized on remand is $12,143 more – an increase of 0.17 percent. Decision at 41.

standard, utilities are "rewarded with an opportunity to earn an 'above-cost' return" when the value of their property increases, but must also accept a lower return when the value of their property declines[117]. The "return" to which utilities are entitled is the dollar amount that they are allowed to earn.[118] Thus, when the value of the assets financed by the capitalization increases, the owners of the assets – the equity investors – expect a higher return. Conversely, when the value of the assets decreases, the owners of the asset expect a lower return. This is the essence of the competitive market, which the fair value standard is intended to mimic.

The Commission ignored this basic rule and, in the process, misstated the holdings of two important Arizona decisions, *Simms* and *Arizona Water*. According to the Commission, those decisions stand for the principle that while "prudent investment theory cannot be used in determining the fair value rate base," the prudent investment theory can be used in determining the appropriate rate of return.[119] Consequently, in the Decision, the rate of return was adjusted downward to produce operating income that is virtually identical to the result produced by using original cost to set rates. On two occasions, Arizona courts have suggested that such rate of return manipulation would be illegal. For example, the Court of Appeals stated that the use of a "fluctuating" rate of return in a fair value setting is unlawful:

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[117] *Duquesne Light,* 488 U.S. at 308-09.

[118] "For regulatory purposes, the rate of return is the amount of money earned by a public utility, over and above operating costs, expressed as a percentage of the rate base." Charles F. Phillips, Jr., *The Regulation of Public Utilities – Theory and Practice* 375-76 (Public Utility Reports, Inc. 1993).

[119] Decision at 22-23. This discussion is further muddled by its erroneous description of the Company's position on page 22, which states that the Company argues that the Commission cannot use the weighted cost of capital to set rates. In fact, the Company contends that the weighted cost of capital should be used to set rates. It has objected to the attempts by Staff and RUCO to manipulate the cost of capital to produce an end result that is equivalent to setting rates based on original cost. The Commission adopted this "end result" approach.

> Under our constitution, a utility is entitled to a fair rate of return on the fair value of its properties, "no more and no less." [Citation omitted.] Dr. Langum [the Staff cost of capital witness] violated this principle by pegging his opinion as to rate of return to the finding of fair value. This results in a fluctuating rate of return. Thus, *under Dr. Langum's theory, it makes no difference whether the Commission used original cost or reproduction cost as the base, the amount of dollars in the Company's coffers is basically the same.*[120]

In sum, the fair value standard requires the Commission to set rates that are based on the current value of the utility's property, not its original cost. As a matter of law, the Commission cannot use fair value as the rate base, and then manipulate the rate of return to produce an end result that is equivalent to using original cost to set rates. It is apparent, however, that the Commission did so in this case. Indeed, RUCO's position – which the Commission adopted – was predicated on manipulating the cost of capital to produce an appropriate "end result." As explained above, this violates Arizona law.

B. <u>The 7.6 Percent Rate of Return Determined in Decision No. 68176 Was Not Based On the Company's Original Cost Rate Base and Should Be Applied to the Fair Value Rate Base</u>

The Commission erroneously stated that the 7.6 percentage rate of return used to set rates in Decision No. 68176 is tied to the Company's OCRB and therefore cannot be applied to a FVRB.[121] This discussion and finding conflict with Decision No. 68176 and with prior Commission practice and policy. The 7.6 percent cost of capital was solely a function of the <u>ratio</u> of debt and equity in Chaparral City's capital structure, and did not depend on either the amount of invested capital or the amount of rate base that was used to set rates. In addition, the 9.3 percent cost of equity – which was affirmed by the Court of Appeals – was based on two <u>market-based</u> finance models that <u>are independent of the</u>

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[120] *Ariz. Corp. Comm'n v. Citizens Utilities Co.*, 120 Ariz. 184, 190 n.5, 584 P.2d 1175, 1181 n.5 (App. 1978) (emphasis added) (quoting *Ariz. Water*, 85 Ariz. at 203, 335 P.2d at 415). *See also Simms*, 80 Ariz. at 155, 294 P.2d at 385.

[121] *E.g.*, Decision at 26-27, 41 ("The WACC of 7.6 percent determined in Decision No. 68176 was based on OCRB.").

rate base to which they are applied. Simple logic indicates that it is appropriate to apply a market-based cost of equity to a market-based rate base.

When the weighted cost of capital is applied to the rate base, it is implicitly assumed that the utility's invested capital is financing that particular rate base, just as in the real world, the investment in an asset (e.g., a parcel of land or common stock) is financing that asset regardless of the asset's current value. The asset's value is based on various economic factors and not the amount originally paid for it. Under the fair value standard, a utility is entitled to a return on the fair value of its assets, not a return on its original investment.[122] The cost of capital methodology can be used to derive that return, as courts in other jurisdictions have squarely held.[123] As explained above, the Company's methodology is consistent with these decisions, while the Decision ignores them.

1. The Weighted Cost of Capital Methodology Is Not Linked to Chaparral City's Original Cost Rate Base

In this case, the weighted cost of capital calculation was based on Chaparral City's actual, adjusted capital structure as of December 31, 2003, and was determined to be as follows:

	Amount	Cost	Weighted Cost	Dollar Return
Long-Term Debt	$8,363,309	5.1 %	2.1 %	$426,529
Common Equity	$11,901,727	9.3 %	5.5 %	$1,106,860
Total Capital	$20,265,036	--	7.6 %	$1,533,390

[122] *See, e.g., Duquesne Light*, 488 U.S. at 308-09.

[123] *E.g., Union Elec. Co.*, 396 N.E.2d at 516; *Duke Power*, 206 S.E.2d at 281; *City of Alton*, 165 N.E.2d at 519-20.

These figures are taken from Decision No. 68176, at pages 16 and 26, and are not in dispute.[124] By contrast, the original cost rate base approved by the Commission was $17,030,765, while the fair value rate base approved by the Commission was $20,340,298.[125] Thus, the capital structure adopted in Decision No. 68176 does not match either the original cost rate base or the fair value rate base. Instead, total capital is greater than original cost by about $3.2 million, and less than fair value by about $75,000.

However, in Decision No. 68176, the Commission did not authorize rates that would produce Chaparral City's cost of capital or allow the utility's investors an opportunity to actually earn 9.3 percent on their equity investment. The nominal increase in operating income proposed in the Decision – $7,441 – likewise fails to produce Chaparral City's cost of capital, as the following table shows:

	Operating Income	Interest Expense	Net Earnings	Return on Equity
Decision 68176	$1,294,338	$426,529	$867,809	7.29 %
Decision	$1,301,779	$426,529	$875,250	7.35 %
Staff (Alter. 1)	$1,289,575	$426,529	$863,046	7.25 %

The return on Chaparral City's equity produced by Decision No. 68176 and the return on equity that would be produced by the new Decision are not only well below the 9.3 percent return on equity authorized in Decision No. 68176, but are virtually identical,

[124] The column entitled "Dollar Amount" was calculated by multiplying the components of the capital structure by their authorized cost. Due to rounding, the total dollar amount, $1,533,390, actually produces a return of 7.567 percent, rather than 7.6 percent. The total annual cost of capital expressed in dollars is actually $1,540,143 ($20,265,036 x 0.076).

[125] Decision No. 68176 at 9.

highlighting the result-driven nature of the Decision.[126]

The foregoing table also highlights the disconnection between a WACC-derived rate of return and original cost. The Commission normally determines the rate of return (in dollars) by multiplying the weighted cost of capital by the utility's rate base. The amounts of debt and equity are irrelevant to this calculation. Instead, the key inputs are the percentages of debt and equity and their respective costs. This is clearly shown in Decision No. 68176, where Chaparral City's 7.6 percent cost of capital was computed.[127] In other words, the Commission assumes that the utility's rate base is financed by the same percentages of debt and equity that comprise the utility's capital structure, without regard to the actual amounts of debt and equity or the size of the rate base. If Chaparral City's total capital was only $16,000,000, but the percentages of debt and equity in its capital structure were the same, the weighted cost of capital would still be 7.6 percent. And if Chaparral City's total capital was instead $26,000,000, but the percentages of debt and equity in its capital structure were the same, the weighted cost of capital would again be 7.6 percent. Because the weighted cost of capital depends on the percentages of debt and equity rather than the amount invested, a WACC-derived return can be used with any rate base, not just an OCRB.

2. The Cost of Equity Is Derived From Market-Based Models That Are Unrelated to Original Cost

The weighted cost of capital is comprised of the weighted cost of debt (which is fixed and does not change) and the weighted cost of equity. The cost of equity is

[126] For comparison purposes, Staff's preferred alternative, which is discussed and approved in the Decision, is also shown. The range of equity returns is only 10 basis points, i.e., they are for all practical purposes identical. As stated, Staff has admitted that its preferred alternative produces the same result as the method used in Decision No. 68176, which was found unlawful by the Court of Appeals. The difference is solely due to rounding. Ex. A-R14; A-R8 at 5-7.

[127] Decision No. 68176 at 26.

unrelated to the rate base that is used to set rates. The two finance models that were used by the Commission to estimate the cost of equity in this case (and in other cases involving Arizona water utilities), the Discounted Cash Flow ("DCF") model and the Capital Asset Pricing Model ("CAPM"), rely on <u>current stock prices and other current market data</u> for a proxy group of water utilities, the stock of which is traded on major stock exchanges.[128] Neither model considers the rate bases of the utilities or Chaparral City's rate base, or uses "book" or accounting equity.[129]

Notably, other jurisdictions sometimes use different methods of estimating the cost of equity, including methods that are accounting-based rather than market-based, such as the Comparable Earnings method. The Comparable Earnings method estimates the cost of equity by using the return earned on book equity investment by firms of comparable risk.[130] In discussing the Comparable Earnings method, Dr. Morin explains:

> The Comparable Earnings approach is far more meaningful in the regulatory arena than in the sphere of competitive firms. Unlike industrial companies, the earnings requirement of utilities is determined by applying a percentage rate of return to the book value of a utility's investment, and not on the market value of that investment. Therefore, it stands to reason that a different percentage rate of return than the market cost of capital be applied when the investment base is stated in book value terms rather than market value terms. In a competitive market, investment decisions are taken on the basis of market prices, market values, and market cost of capital. ***If regulation's role was to duplicate the competitive result perfectly, then the market cost of capital would be applied to the current market value of rate base assets employed by utilities to provide service.*** But because the investment base for ratemaking purposes is expressed in book

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[128] Ex. A-R7 at 10-12; Ex. A-R4 at 16-18, 22-26.

[129] The Commission's Staff admitted, in response to a Company data request, that its cost of capital analysis did <u>not</u> include any information related to the type of rate base to which the cost of capital would be applied. Ex. A-5 at 9 & Ex. 1 (Staff response to data request 2-5).

[130] Roger A. Morin, *New Regulatory Finance* 381 (Public Utility Reports, Inc. 2006).

> value terms, a rate of return on book value, as is the case with Comparable Earnings, is highly meaningful.[131]

In his text, Dr. Morin generally assumes that utility regulators employ a prudent investment/original cost approach, under which utility rates are established based on the book value of the utility's investment in plant as opposed to using fair value.[132] Despite Arizona's rejection of the prudent investment approach, Dr. Morin's discussion of the Comparable Earnings approach is instructive because, as the Supreme Court explained in *Duquesne Light*, the fair value method is intended to mimic the operation of the competitive market.

The Commission, however, does not use Comparable Earnings or other cost of equity estimation methods that rely on accounting-based equity returns.[133] For example, in a contemporaneous decision setting rates for another Arizona water utility, the Commission stated:

> In estimating its cost of equity, Arizona Water relied on a risk premium analysis methodology used by the [California] PUC staff, which uses comparisons to actual or authorized returns on equity. This sort of "comparable earnings" analysis has long been discredited for several reasons, ... Market-based methods like the DCF model and the CAPM provide more reliable estimates of equity cost, because it is capital markets, not regulatory commissions that determine the cost of equity. Use of the risk premium analysis urged by the Company would circumvent the market forces that regulation attempts, as much as possible, to replicate. ... The risk premium analysis methodology erroneously assumes that accounting-based "actual" ROEs are equal to the cost of equity.[134]

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[131] *Id.* at 394-95 (emphasis added).

[132] *See* Ex. A-R5 at 9-10 (discussing Dr. Morin's "Invested Capital Approach" to computing a utility's operating income based on its book investment).

[133] Ex. A-R7 at 11-12.

[134] *Arizona Water Co.*, Decision No. 68302 (Nov. 14, 2005), 37-38.

The Commission's rejection of cost of equity estimation techniques that rely on returns earned on utilities' book or accounting equity is consistent with fair value standard, which considers market values in setting rates rather historic, book investment in plant.

In short, as a matter of common sense, the use of <u>market-based</u> models to estimate the cost of equity is appropriate when the cost of equity is applied to a <u>market-based</u> rate base. Yet in the Decision, the Commission has taken the opposite position – that market-based equity cost estimates can only be used in connection with an accounting-based rate base. In other words, in Arizona, apples should be compared with oranges, not with other apples. This makes no sense. The DCF and CAPM models rely solely on stock prices and market-based data, and do not consider the utilities' "book" investment or the historic cost of building plant. Consequently, a cost of equity that is estimated with those models can certainly be applied to a fair value rate base.

C. <u>Inflation Is Not "Over Counted" By Applying the Rate of Return to the Fair Value Rate Base</u>

The principal justification given for reducing Chaparral City's return on equity from 9.3 percent to 7.3 percent is that the application of the cost of capital to the FVRB would "over compensate" Chaparral City for inflation. As explained below, the evidence in the record does not support reducing the Company's cost of equity, and even if such evidence existed, it would be unlawful to do so without also considering the adverse impacts of inflation on the Company's overall cost of service, including its operating expenses.

In reality, inflation adversely impacts utilities to a far greater extent than other businesses because they cannot adjust their rates in response to price increases, and must wait until new rates are approved following a rate case. For this reason, inflation is continually eroding the Company's earnings. To counteract the erosion of earnings, some jurisdictions have authorized attrition allowances and adjustments to provide the utility with a reasonable chance of actually earning its authorized return on common equity.[135] Here, in contrast, the Commission reduced the Company's 9.3 percent return on equity (which is already very low in comparison to other jurisdictions[136]) by 200 basis points to only 7.3 percent.

1. The "Inflation" Adjustment Is Unsupported by Credible Evidence

The Commission concluded that inflation is being "over-counted" because the cost of equity, estimated by means of the DCF and CAPM models, and the FVRB both include an "inflation component."[137] This "inflation component" is not clearly identified or described, but is instead <u>assumed</u> to be 2 percent of the cost of equity, based on the yields of certain Treasury securities.[138] The Commission then assumed that Chaparral City's FVRB is growing larger each year by an amount equivalent to 2 percent, effectively causing inflation to be over-counted – once in the cost of equity and once in the FVRB. This speculation is erroneous for several reasons.

First, the Company's fair value rate base is not simply the "inflated" cost of its plant. Rather, it is based on the <u>average</u> of its original cost and its reconstruction cost less depreciation ("RCND") rate base. By definition, the original or book cost of the Company's plant contains no inflationary component.[139] Yet, it is half of the Company's fair value rate base! If the rate of inflation is 2 percent, as assumed in the Decision, and

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[135] Phillips, *supra*, n.119 at 407-08.

[136] Ex. A-R2 at 14. In a survey of equity returns conducted by the National Association of Water Companies, the average equity return authorized between 2002 and mid-2006 was 9.9 percent.

[137] Decision at 33.

[138] *Id.* at 34-36.

[139] *See* Decision No. 69176 at 32, 37.

no more than 50 percent of the fair value rate base is actually affected by inflation, the inflation adjustment is overstated by 50 percent, at best.[140]

Second, a substantial portion of the Company's RCND rate base is not affected by inflation. In determining its RCND rate base, the Company did not trend or otherwise determine a current value for its real property, franchises, organizational costs and other intangibles, and these rate base components therefore contain no "inflation."[141] Moreover, a significant portion of the Company's fair value rate base – approximately $3 million – consisted of plant constructed during the test year, and was unaffected by inflation.[142]

Third, the Company presented testimony from Harold Walker, who is an expert on utility valuation techniques, and has personally conducted numerous valuation, cost and depreciation studies for utilities.[143] Mr. Walker reviewed the reconstruction cost new ("RCN") study prepared by the Company and accepted by the Commission in Decision No. 68176.[144] He determined that this study likely understates the Company's total RCN value and that the method used to determine fair value in this case was a very conservative valuation approach.[145]

Fourth, and contrary to the discussion in the Decision, the methodology used to derive the RCND rate base was not based on inflation. The plant was valued by using

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[140] Ex. A-R7 at 37-38; Ex. A-R4 at 44.

[141] Ex. A-4 at 8.

[142] Decision No. 68176 at 3-7 (discussing plant constructed during and after the test year).

[143] Ex. A-R2 at 1-2, App. A.

[144] Decision No. 68176 at 9.

[145] Ex. A-R2 at 3-7.

Handy-Whitman account-specific indexes for water utilities in the Plateau Region.[146] The Handy-Whitman indexes do not measure inflation, nor are they based on general inflation in the economy, but are affected by many variables, as the Company's witnesses explained.[147] For example, the Handy-Whitman average index for Total Gas Plant declined by 4.4 percent during 2006, while other general measures of inflation, such as the Consumer Price Index, were increasing.[148] The reality is that current reproduction cost of Chaparral City's system is affected by a number of different factors, not simply inflation.[149]

Finally, the Decision erroneously assumes that Chaparral City has consistently earned its authorized return on common equity, when there is no evidence supporting that assumption.[150] For example, during calendar year 2006, which was the first full year after the rate increases approved in Decision No. 68176 became effective, the Company's return on equity had already eroded to the point that the Company filed a new application for rate increases.[151] If Chaparral City has been unable to consistently earn its authorized return on equity, there is no basis on which to assume that inflation would be "over counted" by applying the cost of equity to the fair value rate base.

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[146] Ex. A-R2 at 3-4; Ex. A-4 at 7-8.

[147] Tr. at 43-45, 50-51.

[148] A-R7 at 17, 30.

[149] *E.g.,* Ex. A-R1 at 4-5; Ex. A-R4 at 45.

[150] Ex. A-R4 at 46.

[151] *Chaparral City Water Co.*, Docket No. W-02113A-07-0551, Schedules E-2 and E-9 (audited financial statement). During calendar year 2006, the Company's net income was $505,119, which is about $360,000 less than the net income produced by Decision No. 68176.

2. The Decision Engaged in Piecemeal Ratemaking in Violation of Arizona Law and Established Commission Policy.

The Commission also ignored the pernicious effect of inflation on the Company's ability to actually earn its authorized rate of return, including the impacts of inflation on the Company's overall cost of providing service. Because the Commission uses historic test years with limited adjustments for post-test year changes, and does not allow water utilities to implement surcharges and adjustment mechanisms to recover increases in key costs such as purchased power and water,[152] most water utilities are unable to actually recover their authorized equity return.[153] Indeed, during calendar year 2006 (i.e., the first full year after the rate increases authorized in Decision No. 69176 became effective) Chaparral City's net income was only $505,119 – some $360,000 less than the net income anticipated by Decision No. 68176 and $600,000 less than the net income required for Chaparral City to actual earn a return on equity of 9.3 percent.[154]

There is undisputed evidence in the record that the Company's operating expenses are being impacted by inflation to a much greater extent than inflation impacts the Company's rate base or its return on equity.[155] Assuming general inflation of 2 percent annually, as the Commission has done, the Company's <u>operating expenses will increase 2.4 times faster</u> than the Company's operating income, as shown by the schedule attached at Tab. A. This schedule actually understates the impact of inflation because while

[152] Decision No. 68176 at 31-34. Approximately 90 percent of the Company water is purchased from the Central Arizona Project, the cost of which has consistently increased. *Id.* at 31-32. The Company is provided power by both APS and SRP, whose rates have been steadily increasing. *Id.* at 32.

[153] Ex. A-8 at 7.

[154] *See* tables at pages 34-35, above.

[155] Ex. A-R4 at 42-43.

increases in operating expenses must be immediately paid by the Company, any increase in its fair value rate base will only be recognized in rates after another rate case has been completed and new rates established. Thus, after three years, the Company's operating expenses will have increased by nearly $230,000 if the general rate of inflation is assumed to be 2 percent, but any increase in rate base will have no impact on the Company's earnings until the next rate case has been concluded.[156]

In short, the Decision is a prime example of piecemeal regulation. RUCO previously argued in this case that "[b]iased rates result when incremental changes in any one particular cost are adjusted without consideration of changes in all other elements of the Company's cost of service."[157] The Commission agreed with RUCO, and rejected Chaparral City's request to implement adjustment mechanisms to recover increases in purchased power and water expenses in Decision No. 68176 based on the "danger of piecemeal regulation."[158] Yet, by focusing solely on the cost of equity, and ignoring the impact of inflation on the other elements of the Company's cost of service and the resulting rate of return, the Commission has now engaged in piecemeal regulation in violation of Arizona law. *See Residential Utility Consumer Office*, 199 Ariz. at 593, 20 P.3d at 1174; *Scates*, 118 Ariz. at 535, 578 P.2d at 161.

For all of these reasons, the Commission's adjustment to the Company's cost of equity is excessive and unlawful. The Commission has ignored the evidence submitted

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[156] At present, for example, the Company's current rates are based on utility plant and operating expenses as of December 31, 2003. The Company's new rate case, filed in September 2007, was stayed for six months pending the completion of the remand proceeding. *See Chaparral City Water Co.*, Docket No. W-02113A-07-0551, Second Amended Procedural Order (July. 24, 2008). In the meantime, the Company's expenses have been increasing, further eroding the Company's earnings.

[157] RUCO Reply Br. at 7 (July 20, 2005).

[158] Decision No. 68176 at 33.

by the Company's witnesses, including evidence that explains how the Company's fair value rate base was derived, while speculating about the impact inflation might have on the Company's rate base. At the same time, the Commission has ignored the impact of inflation on the Company's cost of service and ability to earn its authorized rate of return, and instead engages in piecemeal ratemaking by considering the cost of equity in isolation. This one-sided approach was result-driven and violates Arizona law.

D. <u>The Company Should Have Been Allowed To Recover A Reasonable Amount Of Rate Case Expense</u>

The Decision denies recovery of any rate case expense for the successful appeal and resulting remand proceeding. Instead, the Decision orders the Company to seek recovery of rate case expense in its pending general rate case. Decision at 43 This remedy is severely flawed. The Company has already requested rate case expense in that case for the expenses incurred in that proceeding. Additionally, expenses for the appeal and remand proceeding were incurred before, during, and after the test year being used in that rate case. This will not only cause needless confusion, but may provide additional arguments against recovery.

The denial of rate case expense further violates fundamental notions of due process. A proceeding to fix rates carries with it fundamental procedural requirements. *State ex rel. Corbin v. Ariz. Corp. Comm'n*, 143 Ariz. 219, 223-24, 693 P.2d 362, 366-67 (App. 1984). This means that when a party meets it burden of proof on an issue, and there is no rebuttal, the party should prevail on that issue. The Company evidenced the amount of rate case expense it had incurred in and for this matter since Decision 68176 was issued. Bourassa Remand Rb. at 9; Bourassa Remand Rj at 21; TR at 66-67. *See also* July 6, 2007 - Amended Notice of Filing Revised Schedules. This evidence further showed the amount requested, $100,000, to be far less than one-half the amount actually incurred, and therefore, reasonable under the circumstances.

Staff and RUCO were provided the back-up documentation for all of the Company's requested rate case expense. Nevertheless, neither Staff nor RUCO challenged the Company's evidence in any manner. RUCO remained totally silent on the issue of rate case expense, while Staff offered several legal and other conjectural reasons why the Company was prohibited from recovering any rate case expense. All of Staff's arguments were rejected in the Decision, which finds that rate case expense is recoverable, just not in this case. Decision at 39. But the decision is still arbitrary and capricious. The undisputed evidence was that the Company incurred more than twice the amount requested as a result of the Commission's Constitutional violation. The Company should have been awarded $100,000 in rate case expense in the Decision.

VI. CONCLUSION

For these reasons, the Commission should rehear this matter and reject the result-driven and unsupported findings and determination of the Decision, and adopt the Company's recommendation and apply the cost of capital, 7.6 percent, to the fair value rate base. The Company's recommendation is consistent with the Arizona Constitution and relevant law because it uses fair value in an appropriate and meaningful way to set rates. The Decision, in contrast, is contrary to fair value standard and again violates Arizona law.

RESPECTFULLY SUBMITTED this 31st day of July, 2008.

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Tab A

Chaparral City Water Company
Analysis of Inflation Impacts on RB and OE

	Per Decision 68176	Period in Years 1	2	3	4	5
Annual Inflation		2%	2%	2%	2%	2%
FVRB	$ 20,340,297					
FVRB after inflation		$ 20,747,103	$ 21,162,045	$ 21,585,286	$ 22,016,992	$ 22,457,331
Increase In RB		$ 406,806	$ 821,748	$ 1,244,989	$ 1,676,695	$ 2,117,034
ROR	7.60%	7.60%	7.60%	7.60%	7.60%	7.60%
Required Oper. Income due to increase in FVRB		$ 30,917	$ 62,453	$ 94,619	$ 127,429	$ 160,895
Operating Expenses[1]	$ 3,722,696					
Operating expenses after inflation		$ 3,797,150	$ 3,873,093	$ 3,950,555	$ 4,029,566	$ 4,110,157
Increase in OE due to Inflation over TY operating expenses		$ 74,454	$ 150,397	$ 227,859	$ 306,870	$ 387,461
Excess (Shortfall) of return $'s over increase in operating expenses		$ (43,537)	$ (87,944)	$ (133,240)	$ (179,441)	$ (226,567)

[1] Exclusive of depreciation, income taxes, and property taxes